

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
WILLIAM L. SCHAFER, BARBARA SCHAFER,)
JACK GERETY, MIRIAM GERETY AND)
PAULINE McDERMOTT GERETY)

Appearances:

For Appellants: James Vizzard, Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax as follows:

<u>Appellant</u>	Year	Amount
William L. Schafer	1952	\$3,446.68
Barbara Schafer	1952	3,446.68
William L. and Barbara Schafer	1953	12,753.33
	1954	13,486.62
	1955	14,461.92
Jack and Miriam Gerety	1952	6,957.26
	1953	13,009.34
Jack and Pauline McDermott Gerety	1954	13,718.26
	1955	9,065.34

Appellants William L. Schafer and Jack Gerety were partners in the San Joaquin Music Co, from 1947 until May 15, 1955, From May 15, 1955, until November 14, 1955, Schafer's partner in the enterprise was Herbert Lightman, From November 15, 1955, through December 31, 1955, Schafer was the sole owner of the business. The Schafer-Gerety partnership established a fiscal year ending June 30. Assessments were made by respondent against the individuals involved based on an audit covering the operations of the San Joaquin Music Co. for the period July 1, 1951, through December 31, 1955. No appeal has been filed by Herbert Lightman.

San Joaquin Music Co, (SJM) operated a coin machine business in the Bakersfield area. It owned bingo pinball machines, with and without multiple-odd features, flipper

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pinball machines, music machines and some miscellaneous amusement machines. It also rented claw machines from a supplier for a fixed monthly rental. The equipment was placed in bars, restaurants and other locations. The maximum number of locations was about 150. The maximum number of bingo pinball machines was 131. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between SJK and the location owner,

As to claw machines, SJM paid to the collector a commission consisting of a certain percentage of the amount the collector retained from locations. The collector was required to make all repairs to the claw machines he serviced. The collector's commission ranged from 33-1/3 percent to 50 percent.

The gross income reported in SJM's records and tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, salaries, commissions and other business expenses. The amount paid to the claw machine collector was recorded as a commission, and federal withholding tax and social security tax were applied to that commission.

There is some indication that initially the claw machines were furnished by the collector. The evidence, however, does not establish the exact nature of this arrangement, the period of time covered (part or all of which may have been prior to July 1, 1951), or the reported gross income from claw machines while this arrangement was in effect. Under the circumstances we cannot do otherwise than consider the claw machine arrangement for the entire period covered by this appeal to be as first stated, namely, an arrangement whereby SJM rented the machines from a supplier and paid a commission to the collector,

Respondent determined that SJM was renting space in the locations where its machines, including claw machines, were placed and that all the coins deposited in the machines constituted gross income to SJM. Respondent also disallowed all expenses pursuant to section 17297 (17359 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

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In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

The evidence as to machines other than claw machines indicates that the operating arrangements between SJM and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of the machines is, accordingly, applicable here .

As to claw machines, Hall supports a conclusion that the location owner was engaged in a joint venture with some other person in the operation of the machines. We must decide, however, whether that other person was SJM or the collector or SJM and the collector jointly.

The claw machines were placed in locations in which SJM already had music or pinball machines and they were placed there through the use of the San Joaquin Music name. It is significant that the three location owners who were witnesses and who had claw machines each said that the machines were owned by SJM. The following are excerpts from this testimony:

Q. Yes. Who owned these machines?

A. I did business with the San Joaquin Music.

* * *

Q. Were the music machine and claw machine owned by the same business?

A. Yes.

Q. And who was that?

A. San Joaquin Music.

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* * *

Q. And who owned them?

A. San Joaquin Music Company.

This understanding on the part of the location owners, coupled with SJM's records showing as income the total of amounts taken by the collector from the locations and labelling as "commissions" the amounts allotted to the collector, leads us to the conclusion that the location owners were engaged in a joint venture with SJM as to claw machines. It follows that of the entire amount of coins deposited in the claw machines, half must be regarded as the gross income of the respective location owners and half as the gross income of SJM.

In Appeal of Advance Automatic Sales Co., Gal St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. _____, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we concluded that the ownership or possession of a pinball machine is illegal under Penal Code sections 330b, 330.1 and 330.5 if the machine is predominantly a game of chance or if cash is paid to players for unplayed free games and we held bingo pinball machines to be predominantly games of chance,

Of the three location owners who were witnesses and who had pinball machines from SJM, two testified that they paid cash to players for unplayed free games and one testified that he did not make such payments. One additional location owner who had a pinball machine from SJM and who was interviewed by respondent's auditor in 1958 but had died prior to the hearing told the auditor that he paid cash to players for unplayed free games. Appellant William L. Schafer told respondent's auditor in 1958 that the collectors reimbursed the location owners for expenses in connection with the pinball machines and that the expenses ran from 10 percent to 50 percent of the gross proceeds in the machines,

We conclude that it was the practice of most location owners to pay cash to players of pinball machines for unplayed free games. The ownership and possession of the bingo pinball machines were thus illegal not only because they were predominantly games of chance but also because cash was paid to winning players. We have previously held the operation of a claw machine to be illegal whether or not a successful player is permitted to redeem the merchandise for cash. (Appeal of Perinati, Cal. St. Bd. of Equal., April 6, 1961, 3 CCH Cal. Tax Cas. Par. 201-733. 3 P-H State & Local Tax Serv. Cal. Par. 58191; Appeal of Seeman,

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Cal. St. Bd. of Equal., July 19, 1961, 3 CCH Cal. Tax Cas. Par. 201-825, 3 P-B State & Local Tax Serv. Cal, Par, 58208.) Inasmuch as there was illegal activity, respondent was correct in applying section 17297.

Almost all of SJM's locations had music machines. Most of the locations also had pinball machines. The claw machines were placed in locations which had music machines or pinball machines or both. SJM's recorded gross income from claw machines and pinball machines ranged from a low of 43 percent to a high of 66 percent of the total recorded gross income for the years in question. The repair of all machines except claw machines was centralized. Some of the collectors collected from both music machines and pinball machines. We conclude that the legal operation of music machines and miscellaneous amusement machines was associated or connected with the illegal operation of pinball machines and claw machines. Respondent was therefore-correct in disallowing all the expenses- of SJM's business.

There were no records of amounts paid to winning players on pinball and claw machines, and respondent made an estimate of the unrecorded amounts,

At the time of the audit in 1958, respondent's auditor interviewed five location owners who had pinball or claw machines from SJM during all or part of the years in question. Two location owners could not give estimates of the average percentage which the payouts bore to the total amount of coins deposited in the machines. Three location owners, however, made estimates of 40 percent, 40 percent, and 60 percent, respectively. Respondent considered these three estimates together with the 10 to 50 percent estimate given by appellant William L. Schafer and computed the payouts as equal to 40 percent of the coins deposited in the pinball and claw machines.

As we held in Hall, supra, respondent's computation of gross income is presumptively correct. Appellants have not offered any evidence that respondent's computation was excessive. Respondent's method of computing the unrecorded gross income was reasonable under the circumstances and it is sustained,

Appellants have raised a question as to whether the notices of proposed assessment were timely,

The notices of proposed assessment were issued by respondent on March 23, 1959. The returns for the years 1952, 1953, 1954 and 1955 were due on April 15, 1953, 1954, 1955 and 1956,

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respectively, (Rev. & Tax, Code, Par. 18432,) The notices of proposed assessment for 1954 and 1955 were issued less than four years after the due date of the returns. The notices of proposed assessment for 1952 and 1953 were issued more than four years and less than six years after the due date of the returns,

Section 18586 of the Revenue and, Taxation Code provides a general four-year period for respondent to issue a notice of proposed assessment. Section 18586.1 extends the period to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. Under either section, the time starts to run upon the filing of a return, except that if the return is filed prior to the final date for filing, the time starts to run on such final date. (Rev. & Tax, Code, Par. 18588.)

The notices of proposed assessment were timely for the years 1964 and 1955 under the general four-year limitation. The amounts of gross income not reported for 1952 and 1953 were the appellants' distributive shares of SJM's portion of the amounts claimed by the location owners for expenses and deducted from the proceeds of the machines prior to the equal division. The actual figures of reported and unreported gross income are as follows:

1952

Partnership reported gross income	\$112,451.26
Half of partnership income to Gerety	56,225.63
Other income reported by Gerety	3,137.01
Gerety total	59,362.64
25 percent thereof	14,840.66
Half of partnership income to Schafer	\$ 56,225.63
Other income reported by Schafer	1,800.00
Schafer total	58,025.63
Half to William L. Schafer	29,012.82
25 percent thereof	7,253.20
Half to Barbara Schafer	29,012.81
25 percent thereof	7,253.20
Unreported gross income of partnership	32,132.66
Gerety share	16,066.33
William L. Schafer share	8,033.17
Barbara Schafer share	8,033.16

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1953

Partnership reported gross income	\$174,167.87
Half of partnership income to Gerety	87,083.94
Other income reported by Gerety	12,874.15
Gerety total	99,958.09
25 percent thereof	24,989.52
Half of partnership income to Schafer	87,083.94
Other income reported by Schafer	None
Schafer total	87,083.94
25 percent thereof	21,770.98
Unreported gross income of partnership	71,416.50
Gerety share	35,708.25
Schafer share	35,708.25

For each of the years 1952 and 1953, the unreported gross income of appellants William L. Schafer, Barbara Schafer, Jack Gerety and Miriam Gerety exceeded 25 percent of reported gross income and the notices of proposed assessment for these years were, therefore, timely.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax as follows:

<u>Appellant</u>	<u>Year</u>	<u>Amount</u>
William L. Schafer	1952	\$ 3,446.68
Barbara Schafer	1952	3,446.68
William L. and Barbara Schafer	1953	12,753.33
	1954	X3,486.62
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<u>Appellant</u>	Year	Amount
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	1953	13,009.34
Jack and Pauline McDermott Gerety	1954	13,718.26
	1955	9,065.34

be modified by recomputing gross income in accordance with the opinion of the board. In all other respects the action of the Franchise Tax Board is sustained,

Done at Pasadena, California, this 27th day of November, 1962, by the State Board of Equalization,

George R. Reilly, Chairman
- Richard Nevins, Member
- Paul R. Leake, Member
John W. Lynch, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary